Economic Monitor

HOUSE COMMITTEE ON THE BUDGET
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PROMOTING JOB GROWTH AND ECONOMIC EXPANSION

HOW RECENT POLICIES ARE HELPING

The strong rebound in real gross domestic product [GDP] growth in the first quarter, at a 5.8-percent annual rate, indicates the recession that began in March 2001 is over, according to most forecasters. The Blue Chip forecasters project continued real GDP growth at moderately strong rates during 2002 and 2003 – in the 3-percent to 4-percent range. Such growth should not be taken for granted, however, especially with unemployment at 6.0 percent in April.

The mildness of last year's recession, and the improving prospects for the economy, may be little consolation at this time for those who continue to face significant hardships from lost wages or jobs, or declining business. As discussed last month in the Budget Committee's *Economic Update*, the employment situation is expected to improve, though it may lag behind the rebound in GDP.

Nevertheless, it is increasingly clear that policies adopted by Congress and the President over the past year were well-timed to alleviate recessionary pressures and promote economic recovery and job growth. Without these policies, the recession – and the increase in unemployment – would have been worse, and the recovery less robust. Beyond the short-run benefits, these policies also will promote sustained expansion and longer-term growth – if they are kept in place.

A Mild Recession

Current data show that the fall in real GDP during last year's recession was the mildest such decline on record. Last year's tax relief measure, enacted in June, played an important role in keeping the recession from being more severe.

Recognizing the need for immediate stimulus to the economy – which was already in the early stages of recession, as revealed later – the Economic Growth and Tax Relief Reconciliation Act of 2001 [EGTRRA] included $36 billion in rebate checks mailed to 85 million taxpayers. Other components of the legislation lowered taxes by an additional $20 billion in 2001 and $69 billion in 2002.

These tax reductions helped to bolster spending at precisely the time it was needed. Notes the Congressional Budget Office [CBO]: "[I]n contrast to most past recessions, when significant lags accompanied the adoption and implementation of fiscal stimulus, a major source of stimulus this time began in only the fourth month of the recession (July 2001) in the form of tax rebates." (CBO, *The Standardized Budget and Other Adjusted Budget Measures*, April 2002) The Council of Economic Advisers has estimated that, without the tax cuts, real GDP growth rates would have been adversely affected by more than a full percentage point at an annual rate in the second half of 2001, and by about a half percentage point during 2002. (Council of Economic Advisors, "President Bush's 2001 Tax Relief Softens the Recession," 14 February 2002)

A second important step for promoting economic recovery came with the Job Creation and Worker Assistance Act of 2002, enacted in March. The measure included partial expensing of equipment investment and extended unemployment insurance benefits. Thus, these provisions were targeted precisely at the areas of most weakness in the economy: declining business equipment investment and higher unemployment. Estimates of the economic effects reveal that the stimulus legislation likely will boost real GDP growth by as much as ½ percentage point per year during the 2002-03 period. The measure also is expected to

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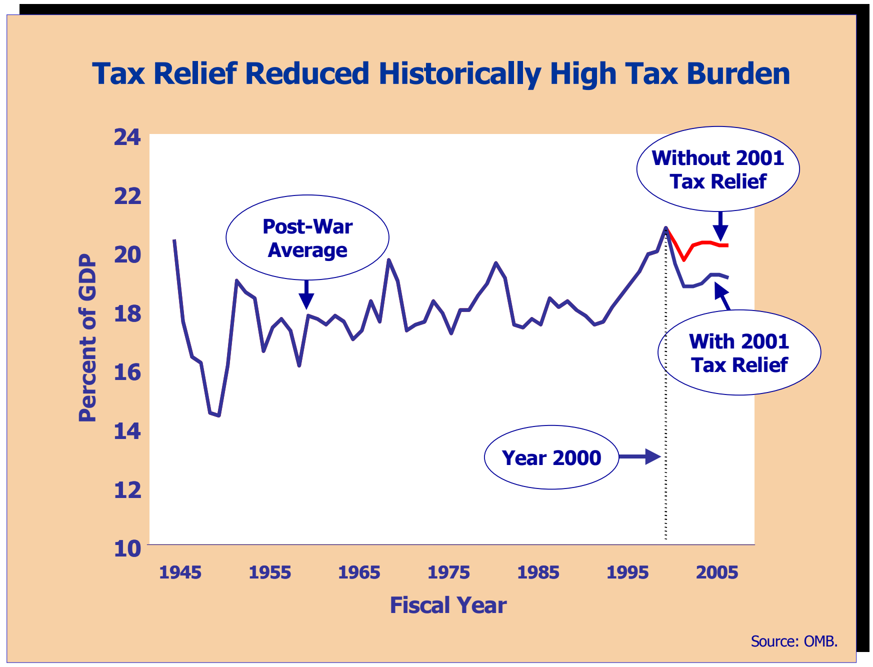
promote a faster recovery in payroll employment by as many as 500,000 jobs by the end of 2003.

Benefits From Reducing Excessive Taxation

Although the tax rebates of the June legislation and their short-run benefits received much of the attention, the more fundamental elements of the Economic Growth and Tax Relief Reconciliation Act can be expected to promote longer-term growth.



The chart alongside shows that prior to the tax relief, Federal taxes reached historic highs as a percent of GDP in the late 1990s and 2000. Some of that increase was related to the cyclical performance of the economy; but as recent CBO estimates confirm, a significant part represented an ongoing higher "structural" tax burden independent of cyclical factors. The excessive level of taxation also was reflected by large noncyclical, or "structural," budget surpluses that were developing. The historically high level of taxation relative to GDP, coupled with large and growing structural surpluses, created a "fiscal drag" on the economy. In general, excessive tax levels – especially high marginal personal income tax rates – retard the ability of the private sector to undertake productivity-enhancing investment and to allocate resources to their most efficient use.

The package of tax measures passed in June reduced the excessive tax burden, including reductions in marginal income tax rates, increased child tax credits, reductions in the "marriage penalty," education tax incentives, estate and gift tax relief, and other provisions. Over time, the marginal tax rate reductions of the legislation will promote long-run economic activity by raising after-tax real wages and reducing the after-tax cost of capital for entrepreneurs and proprietors. These effects will promote labor force participation and private fixed investment, key building blocks of long-run potential output. Mindful of the measure's long-term benefits, the House of Representatives on 18 April passed H.R. 586, making the tax cuts permanent.

Staying the Course

The policies adopted by Congress and the President – coupled with the aggressive interest rate cuts on the part of the Federal Reserve – were the appropriate response to last year's recession. During a slowdown, the short-run shift to a temporary structural budget deficit is a proper policy stance.

The structural position of the budget is expected to return toward balance as additional short-run budget costs associated with rebuilding, recovery, and enhanced security spending following September 11 phase down from their initially elevated levels, and as the economic stimulus legislation phases out.

From a longer-run perspective, a fundamental role for government is to promote a social and economic environment conducive to rising productivity and stronger economic growth. The House budget resolution – A Wartime Budget to Secure America's Future – explicitly recognized the need to provide for that environment by providing for domestic and international security (via Security for the Nation, Security of a Growing Economy, and Security for Ourselves and Our Families' Future).

The need to maintain the proper environment ultimately requires keeping spending growth under restraint, and keeping the tax burden as low as possible.